USAID Trade Project

Trade Finance Landscape – Pakistan, Afghanistan and Central Asia

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Acronyms & Initialisms

ACU	Asian Clearing Union
ADB	Asian Development Bank
ADR	Advance Deposit Ratio
AfDB	African Development Bank
AIRB	Advanced Internal Ratings-Based
APTTA	Afghanistan-Pakistan Transit Trade Agreement
AVC	Asset Value Correlation
BATF	Bankers Association for Trade and Finance
BEEP	Business Environment and Enterprise Performance
Bps	Basis Points
CAMEL	Capital, Asset Quality, Management Capacity, Earnings Quality and Liquidity
CAR	Central Asian Republic
CAR	Capital Adequacy Ratio
CAREC	Central Asia Regional Economic Cooperation
CGFS	Committee on Global Financial System
EBRD	European Bank for Reconstruction and Development
ECA	Export Credit Agency
ECGD	Export Credits Guarantee Department
EDC	Export Development Corporation
EFIC	Export Finance and Insurance Corporation
EPB	Export Promotion Bureau
EU	European Union
EXIAR	Russian Agency for Export Credit and Investment Insurance
Exim	Export-Import
FBR	Federal Board of Revenue
FX	Foreign Exchange
GDP	Gross Domestic Product
GIEK	Garanti-Instituttet for Eksportkreditt
GNI	Gross National Income
GoP	Government of Pakistan
HBL	Habib Bank Limited
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IMF	International Monetary Fund
IsDB	Islamic Development Bank
ITC	International Trade Centre

JBIC	Japan Bank for International Cooperation
KEIC	Korea Export Insurance Corporation
KP	Khyber Pakhtunkhwa
LC	Letter of Credit
LCR	Liquidity Credit Ratio
LTFF	Long-term Financing Facility
MDB	Multilateral Development Banks
MoC	Ministry of Commerce
NBFI	Non-Bank Financial Institution
NBKR	National Bank of the Kyrgyz Republic
NBP	National Bank of Pakistan
NPLs	Non-Performing Loans
NSFR	Net Stable Funding Ratio
OECD	Organization for Economic Cooperation and Development
PEFGA	Pakistan Export Finance Guarantee Agency Limited
PKR	Pakistani Rupee
RoA	Return on Assets
RoE	Return on Equity
RPA	Risk Participation Agreement
SBP	State Bank of Pakistan
SCB	Standard Chartered Bank
SME	Small and Medium Enterprise
SMEDA	Small and Medium Enterprise Development Authority
TEPI	Trade Export Promotion and Industry
TFFP	Trade Finance Facilitation Program
TFLOC	Trade Finance Line of Credit
UN	United Nations
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
USAID	United State Agency for International Development
USD	United States Dollar
WB	World Bank
WTO	World Trade Organization

Executive Summary

This research is one of four topics being studied to assess the overall potential to expand trade and raise awareness among stakeholders on key issues pertaining to regional trade and economic integration between Pakistan, Afghanistan and the CARs. Despite complementary resource needs to sustain economic growth and generate employment, the lack of availability of trade finance remains one of the critical limiting factors for increasing trade in the region.

Currently, trade between CARs is mostly supported by advance payments, cash on delivery, or a local partner arrangement, as opposed to formal trade finance instruments. This is primarily due to poor credit ratings of Central Asian banks, lack of customized regional financial instruments to support trade, absence of reliable insurance or guarantee schemes, limited awareness of local markets, language differences, and other administrative barriers such as visa issuing and varying institutional requirements. There have, however, been attempts made at substituting bank risk with financing facilities introduced by the Asian Development Bank (ADB) and the International Finance Corporation (IFC). Such efforts are limited and only target a small portion of potential trade opportunities.

There is significant potential for trade between Pakistan and the CARs in sectors such as cotton, machinery, fuel, and energy. This potential, however, is not being tapped mainly due to a lack of regional coordination, particularly at the central bank level. Key factors restricting trade among CARs include a lack of availability of appropriate trade finance, including low access to finance for Small and Medium Enterprises (SMEs). Increasing the availability of trade finance instruments would not only require initiatives by commercial banks but also by central banks of Central Asian countries.

Compared to the CARs, Pakistan possesses a relatively more robust banking infrastructure to facilitate private sector trade. Most banking systems in the CARs do not have sufficient liquidity and have low levels of financial intermediation, as evidenced by large interest spreads between lending and deposit rates. The prevalent banking systems in Uzbekistan and Turkmenistan remain predominantly state-controlled, and the Kyrgyz banking system is largely influenced by banks in Kazakhstan.

Banks in Pakistan provide almost a complete range of trade finance facilities, but have only limited credit facilities to support export finance (credit risk). Bank loans to SMEs that contribute significantly to Pakistan's exports account for only 6.5% of total bank loans.[1] This significantly hampers the ability of SME exporters in Pakistan to explore export opportunities in Central Asia. The State Bank of Pakistan (SBP) is currently in the process of establishing an Export Credit Agency (ECA) to support exports from Pakistan to countries where bank risk or other conditions may not be conducive for trade.

Some suggested initiatives to facilitate trade by addressing key challenges include:

- Reduction in the mark up rate (interest rate) by 200-300 basis points (bps) could increase the volume of loans to traders.
- The National Bank of Pakistan (NBP) and Habib Bank Limited (HBL) could offer acceptance/ usance Letters of Credit (LCs) for Central Asian importers to import from Pakistan, backed by credit enhancement either from the Government of Pakistan (GoP) or from the ADB and IFC.
- Development of a regional Export Credit Agency (ECA) and Exim (Export-Import) Bank in Pakistan to help mitigate risks for exporters and importers by assuming commercial and political risks in the country of import.
- Commercial banks like HBL and NBP that are present in both Pakistan and Central Asian countries could develop a program to facilitate investment by companies in the region, and establish regional supply chains with assistance from Multilateral Development Banks (MDBs).

[1] State Bank of Pakistan

- Regional central banks, MDBs, and donor agencies could help develop regional partial guarantees/funding schemes for lending and providing trade finance facilities to SMEs engaged in, or with potential to engage in, regional trade.
- Establishing a regional development bank for Pakistan, Afghanistan, and the CARs, instead of intervention by MDBs. The regional development bank should be owned by countries in the region since they are aware of their regional dynamics and financing needs.
- Harmonization of financial sector policies and institutions between Pakistan, Afghanistan and the CARs, and associations of bankers.
- Development of a regional impact equity fund.

Methodology

For the purpose of this study both primary and secondary sources of data were used.

Primary Data

Interviews were conducted with stakeholders including importers and exporters of sports goods, surgical equipment, fruits and vegetables, general traders dealing in sugar, rice and cement manufacturing, various chambers of commerce, the World Bank, ADB, SBP, NBP, Standard Chartered Bank (SCB) and the Small and Medium Enterprise Development Authority (SMEDA). Interviews and discussions with stakeholders provided insight into the formal and informal financial mechanisms currently used by traders doing business in the region, and trade barriers pertaining to the banking and trade finance infrastructure.

Secondary Data

Information on trade between Pakistan, CARs and Afghanistan has been sourced from the International Trade Centre (ITC) Trade Map tool. Bilateral and multilateral trade finance agreements have been sourced from data available on the Central Asia Regional Economic Cooperation (CAREC) website. Information on the policy and regulatory framework of Pakistan has been collected from policy documents available on websites of the Ministry of Finance, Ministry of Commerce (MoC), and SBP.

References from secondary research sources have been cited in the report.

Trade Finance Products and Services - International Landscape

The international landscape of trade finance products such as documentary collections, bank guarantees, and short/medium term financing are typically uniform. A brief description of commonly offered trade finance products and services is provided below.

Documentary Credits

Export and Import LCs offer assurance of payment on international trade transactions. Due to the nature of international dealings, with factors of consideration such as distance, differing laws in each country and difficulty in knowing each party personally, the use of LCs has become an important aspect of international trade. The bank also acts on behalf of the buyer (holder of LC) by ensuring that the supplier will not be paid until the bank confirms that the documents are in compliance with the terms of the LC.

Standby Letters of Credit and Guarantees

These instruments demonstrate financial capability to suppliers or customers without having to provide cash as a security. They are normally used to secure the fulfillment of contractual obligations such as repayment of an advance payment if no delivery is made or compensation in case of non-delivery or defect delivery. When the buyer and supplier have agreed on the contract terms, they need to define which of those terms are to be secured by a Standby Letter of Credit or Guarantee.

International Collections

International collections ensure delivery of goods to a buyer when payment has been received. The buyer and supplier agree that payment is to be made by Collection, after which goods are shipped along with all documentation (e.g., invoice and transport documents) through the buyer's bank to the collection agent. The collection agent advises the buyer on the arrival of all documentation and the buyer then gets access to the documents against payment to the collection agent. The two common types of collections are:

- Clean Collections: A Clean Collection implies collecting payment of a financial instrument; for example, a bill of exchange or promissory note or the like, without presentation of any shipping documents.
- Documentary Collections: Documentary Collections are used in international trade where both buyer and supplier need to secure their respective interests. In the case of documentary collections, the buyer is allowed to obtain possession of goods by presenting an original transport document to the shipping company (i.e., a bill of lading).

Working Capital Solutions

Working Capital solutions allow for greater control and transparency of accounts payable and receivable, improved cash flow and profitability, and can promote deeper supply chain relationships.

- Supply Chain Finance
  - Payables/Receivables Financing
  - Discounting of Accepted Collections
- Government Assisted Programs
  - Export Guarantee Program
  - Exim Bank Working Capital Guarantee Program

Project Finance

Project finance is offered to start-ups and new projects, and is normally determined by the project's future cash flow. Typically, a new project company is created with little equity, and initially, limited assets. The credit analysis is therefore based on the ability to estimate future earning streams and secure them along with the assets, to obtain credit.

Structured Finance

Under structured financing, either the supplier provides buyers with financing that is then re-financed by financial institutions, or the supplier arranges credit facilities from financial institutions for buyers.

Availability of Trade Finance Products in Pakistan and CARs

Despite the challenges faced by the banking sector in the CARs, banks operating in the region offer most of the aforementioned trade finance products and services.
Commonly available trade finance products and services include:

1. Opening of LCs
2. Acceptance of bills of exchange under LCs
3. Advising LCs
4. Issuing letters of guarantee
5. Documentary collection for imports and exports

Access to working capital finance will be discussed in the section on banking infrastructure in Pakistan and the CARs.

Table (1) presents a comparison of the schedule of charges for various trade finance products offered in Pakistan and the CARs.

Table 1: Schedule of Charges: Pakistan and the CARs

Trade Finance Instrument[2]	Kyrgyzstan	Tajikistan	Kazakhstan	Uzbekistan	Turkmenistan	Pakistan
Letters of credit – interest is declining balance unless designated as flat rate						
Opening commission	1% per quarter or part thereof (min. USD 50)	0.2% (min. USD 50, max. USD 2,000)	0.2% (min. USD 100, max. USD 1,300)	0.3% + USD 30 for SWIFT expenses (min. USD 200+ foreign banks' expenses)	0.1% (min USD 100, max. USD 3,000 per month)	Up to 0.40% for 1st Qtr. or part thereof, Up to 0.25% for subsequent Qtr., Min Rs. 2,200 (USD 22)[3]
Acceptance commission	0.5% (min. USD 50)	Based on agreement	0.2% (min. USD 100)		0.15% of amount of documents (min. USD 100, max. USD 3,000)	
Payment commission	0.5% (min. USD 50, max. USD 1,000)	USD 10 per tranche	0.15% (min. USD 100, max. USD 800)	0.05% from sum of amount (min. USD 50, max. USD 300)		
Advice of letter of credit or its amendments	USD 100	0.2% from amount (min. USD 50, max. USD 500)	USD 50		USD 100	USD 60 (flat)
SWIFT charge	USD 15	USD 40 per SWIFT	USD 20			
DHL/Postage	USD 50	Actual	On actual cost			
Amendments	For amendments that either increase the amount or extend the validity of LC, the appropriate opening commission will apply	From 0.15% (min. USD 50, max. USD 500) From 0.2% (min. USD 100, max. USD 700)	Increase of the amount of guarantee is considered as issuing of a guarantee to accrue commission fees	0.3% + USD 30 for SWIFT expenses (min. USD 200 + foreign banks' expenses)*	Increase amount of letter of credit "Issue of letter of credit"	USD 30
	USD 100	USD 20	USD 100		USD 75 - 100	
Letter of guarantee						
Commission	6% per annum	0.3% from total amount letter of	0.2% (min. USD 100, max. USD 1300)	1%	0.25% (min USD 200, max USD 5,000)	0.40% per quarter

[2] Table is used as proxy indicator for level of charges in each country. Schedule of charges of 2-3 banks in each country was reviewed and the bank with mid-level charges was selected to be included in the table.
[3] XE Currency Converter, August 13, 2014

		credit (min. USD 150) Based on agreement (min. USD 250)				
Documentary collections						
Documentary collection (import and export)	0.3% of amount (min. USD 100, max. USD 1,000)		Import 0.15% (min. USD 30, max. USD 300)			Sight Rs.1,000/- (USD 10.2) Usance Commission @ 0.10% p.m. or part thereof min. Rs.1,000/- (USD 10)[4]
Commission	0.5% (min. USD 50, max. USD 1,000)	USD 40	0.20% (min. USD 50, max. USD 500)			
Validation of bill	Subject to negotiation		0.25% of the amount (min. USD 30, max. USD 300)			
Payments tracking	USD 5,000					
SWIFT	USD 2,000					

Global Utilization of Trade Finance

Trade finance allows importers and exporters to unlock the liquidity tied in trade transactions and mitigate counterparty risk. Among all forms of credit, trade finance is located at the short-term, high collateral, low-risk, and mostly self-liquidating end of the credit spectrum.

Bank intermediated trade finance accounts for an estimated one-third of the total global trade of USD 18 trillion[5], with relatively higher utilization levels in emerging market economies. Bank products for trade include both those products that are directly tied to trade transactions and those that are indirectly related to trade transactions. LC is the most common product directly related to trade transactions. It remains one of the most popular forms of trade finance products, accounting for 8.3% of the global trade share.[6] In the Asia-Pacific region, however, LC is an even more important instrument for trade and accounts for 50% of overall trade finance transactions in the region, significantly higher than its global trade share. This is likely due to relatively newer commercial relationships, long-distances, and weaker financial system development and recovery regulations in the region.

Overall, trade finance accounts for almost USD 10 trillion[7] of the total estimated global trade. This includes indirect trade financing, such as working capital, obtained by export-oriented companies to manufacture goods for export, and import finance/usance LCs to import machinery and raw material for processing and onward export.

[4] XE Currency Converter, August 13, 2014
[5] Committee on Global Financial System (CGFS) - Trade Finance: Developments & Issues, *January 2014*
[6] Ibid
[7] Ibid

Non-bank intermediated forms of trade credit, mostly used by exporters in Pakistan for trade with the CARs, include inter-firm credit under open account trade and advance payment arrangements. Under open account trade transactions, the shipment/delivery of services by the exporter is made prior to receiving payment from the importer. In the case of advance payment, the importer makes the payment prior to receiving the shipment of goods and delivery of services. Both non-bank and bank trade finance benefit from trade insurance that currently accounts for USD 1.7 trillion.[8] New forms of trade finance include supply chain financing where banks automate document processing, often linking it with trade finance, and bank payment obligation that offers similar payment risk coverage as under an LC without the bank handling documents. Complex supply chains also include SMEs in developing countries; financing to such SMEs could be a major source of trade finance within the global supply chain.

As emerging markets and transitioning economies in developing Asia, CARs require banks that have credit risk ratings acceptable to international banks and sufficient availability of liquidity to offer trade finance products and services to their corporate clients. Therefore, the volume of trade finance utilization in CARs remains heavily dependent on trading partner country banks' confidence in the CARs' banking systems. Such confidence can be built and sustained with a robust financial infrastructure and strong banking system.

Regulatory Framework for Trade in Pakistan

Strategic Trade Policy Framework 2012-2015

On January 30, 2013, the Pakistan MoC introduced a Strategic Trade Policy Framework 2012-2015 (instead of annual trade policies) to address the concerns of the business community and trading partners regarding frequent policy shifts. On March 8, 2013, the MoC issued an Export Policy Order 2013 and an Import Policy Order 2013 under the Imports and Exports (Control) Act 1950. Other frameworks include the Foreign Exchange Manual 2002 and the Export Finance Scheme.

The Strategic Trade Policy Framework 2012-2015 identified certain principal elements that would contribute to increasing exports from Pakistan. The Policy Framework explicitly identifies the GoP's priority to increase regional trade with South Asia, China and CAREC countries including Tajikistan, Kyrgyzstan, Afghanistan, Turkmenistan, Uzbekistan and Kazakhstan. Trade finance-related initiatives that would directly influence trade between Pakistan and Central Asia include:

1. Establishing an Exim Bank and an ECA to provide exporters with financing and guarantee facilities that are presently not available through commercial banks or are available at high rates. The Exim Bank and ECA would provide long-term financing and reduce the exporter's risk. The GoP has announced an Exim bank as a budget initiative in 2014 and allotted PKR 10 billion[9] for its establishment.

2. Long-term Financing Facility (LTFF) available through SBP would be provided at a 2% concession to manufacturer and exporter companies engaged in the following sectors: leather, engineering, horticulture, processed food, marble and granite, sports goods, and computer-related services. There is a significant potential for Pakistan and the CARs to trade in the mentioned sectors and the purpose of financing under LTFF is to increase investment in production capacity of the manufacturer and exporter. The estimated cost of the incentive is PKR 3 Billion[10] for 2012-2015.

[8] Ibid
[9] Government of Pakistan, Ministry of Commerce: Strategic Trade Policy Framework 2012-15
[10] Ibid

3. An Export Finance Scheme provided by SBP offers financing at a rate lower than that of the market. The market rate is currently at a maximum of 11% with banks accessing refinance from SBP at 10% and the allowance to charge a maximum premium of 1% from the borrower.[11] It has been proposed that for the following sectors the rate of financing under the Export Finance Scheme be further reduced by 1.5%: fish and fish preparation, processed foods, meat and meat preparations, sports goods, footwear, leather products, surgical goods, cutlery, onyx products, pharmaceuticals, electric fans, transport equipment, and electrical machinery. This reduction in the rate is expected to cost PKR 1.2 billion from 2012-2015.[12]

4. A mark-up subsidy of 50% would be provided for establishing meat processing plants in border areas such as Khyber Pakhtunkhwa, Balochistan, and Gilgit-Baltistan. This would increase Pakistan's potential for processed meat exports to neighboring countries and the CARs.

Foreign Exchange Manual

Exports from Pakistan: As per the Foreign Exchange Manual, exporters are required to register with the Export Promotion Bureau under the Registration of Importers and Exporters Order 1993, and use their registration number on all correspondence with banks dealing in export documents. Details of the exports are to be declared by the exporter on "Form E" to the customs and postal authorities, except for exports to Afghanistan. The total value of the export is to be received in an approved manner by the due date or within 6 months of the shipment date, whichever is earlier through an authorized dealer in a convertible foreign currency that the authorized dealer maintains an account in, or in USD or PKR from a non-resident bank account. As an exception to the above, payment of export proceeds may also be received from a foreign currency account maintained in Pakistan, including an account maintained by the exporter. Payment due for exports from Afghanistan is to be repatriated in foreign currency and sold to the authorized dealer against the PKR.

The title of cargo documents such as Railway Receipts, Bill of Lading, and Truck Receipts are to be drawn on the name of the authorized dealer, unless the authorized dealer issues a certificate to allow for issuance of the title of cargo document in the name of the importer. This certificate would only be issued in case of receipt of advance payment or against an irrevocable letter of credit that requires the title of cargo to be drawn in the name of the LC opening bank, the importer, the exporter, or to an order and blank endorsed. This condition, however, is not applicable on exports of fruits, vegetables, fresh fish, poultry, and perishable items. The authorized dealers will endorse the title of cargo documents in favor of their foreign correspondent bank only. In case of exports through foreign intermediary countries, the authorized dealer may make blank endorsements against receipt of advance payment or where an irrevocable letter of credit allows for blank endorsement.

The exporters are required to submit the complete set of export documents to the authorized dealer within 14 days of the date of shipment. Exporters are allowed to receive partial advance payment and receive the remaining after delivery and shipment of goods. In case of receipt of advance payment by the authorized dealer, the exporter will be disbursed the payment after the authorized dealer receives a certificate from the exporter declaring the particulars of the intended exports. The exporter is required to certify the "E Form" within one year of receipt of the advance payment.

Imports to Pakistan: The MoC under the Imports and Exports (Control) Act 1950 regulates imports into Pakistan. All importers have to register with the EPB under the Registration (Imports and Exports) Order 1993.

[11] Ibid
[12] Ibid

Imports are allowed under LCs, against documents received for collection, against firm contracts, or against clean remittance. LCs should be opened by authorized dealers only on the basis of firm commitment accepted by the exporter and an invoice or performa invoice. The value of the LC should not be less than PKR 1,500,000. The details of the imports need to be submitted on "Form I" by the importer to the authorized dealer. Import payment can be made in any foreign currency, in PKR to a non-resident bank account of the country of the beneficiary, or through the Asian Clearing Union (ACU) clearing arrangement where the shipment is from an ACU member country. LCs can be opened for a period of 12 months, except in the case of machinery and mill work which are required to be specifically manufactured, and in cases where the period of manufacture is more than 12 months.

The "Law on Banking and Banking Activity" broadly covers regulation of permissible banking activities in the CARs. Authorized banks are allowed to make foreign currency transactions for imports and exports subject to the legislation of each country. The companies engaged in foreign currency transactions are obliged to maintain records and report their transactions to the local authorities.

Current Mode of Trade between Pakistan and Central Asia

Export products from Pakistan are mostly transported to Central Asia by a land route through Afghanistan. In some cases, this requires additional arrangements to be made by the exporter for the safe passage of cargo through Afghanistan, particularly during the 8-9 months when the Solang tunnel linking Afghanistan and Tajikistan is closed. Traders or middle-men purchase cargo from local manufacturers against payment, and have the cargo delivered to their local contacts in Central Asian countries. These traders have established offices in Afghanistan to ensure the safe passage of cargo and to unload cargo from large trucks and reload it into smaller trucks when the Solang tunnel is closed. When the cargo is unloaded in Afghanistan to be reloaded for re-export to the CARs, it is considered by Pakistan as an export to Afghanistan. The payment to the manufacturer is made through banking channels in Pakistan while the middle-man receives payment in a bank account in Afghanistan.

The second mode of export is to send the cargo to a partner in the importing CAR or to the exporter's own office through the land route in Afghanistan or through a sea route to Europe. The payment made could either be through unofficial means or through a banking channel, depending on the fiscal and financial disclosure levels of the exporter.

Export against LCs appears to be limited in the trade between Pakistan and Central Asia. One reason for this could be low levels of risk acceptance of LCs from Central Asian banks. Another reason for the limited use of LCs in the region could be the high cost of in-transit insurance in Afghanistan. The informal risk coverage provided by the offices of traders and middle-men addresses the insurance and re-export challenges from Afghanistan.

The 2005 Business Environment and Enterprise Performance (BEEP) survey conducted by the European Bank for Reconstruction and Development (EBRD) and the World Bank states that SMEs and large firms in Central Asia have to transact either in cash for input purchases or provide advance payment. It further elaborates that supplier credits were as little as 10% of total purchases of SMEs (15% for large firms) while advance payment accounted for almost 50% of input purchases for large firms. More than 50% of SME purchases were paid in cash. For SME importers, the advance payment requirement is even higher than the SME average (importing SMEs included).[13] All firms in the survey demonstrate that internal funding is the main source of working capital finance. Only 12-20% of the working capital requirement was met by external sources.[14] The main source of external funding was bank borrowings, both from the government and private sector, as well as trade credits. Small enterprises, however, relied relatively less on government bank loans compared to medium

[13] Asian Development Bank Institute, " Financial Crisis, Trade Finance, and SMEs: Case of Central Asia," (2010)
[14] Ibid

enterprises. Moreover, SMEs had a heavier reliance on family loans, which large enterprises did not. Large enterprises, on the contrary, relied more heavily on foreign bank borrowings.

The above findings point toward circumvention of the banking system to finance trade and businesses in the CARs, potentially due to the following issues:

1. Risk of trade transactions with traders and banks in CARs is significant for international trading counterparties
2. Low access to finance is inhibiting growth of enterprises and trade. According to the IFC's Enterprise Survey, the table below shows that access to trade credit financing available in the CARs is below the average for Eastern Europe and Central Asia.

Table 2: Trade Credit Finance in the CARs[15]

Trade Credit Financing for Investment (%)	Country Indicator	Eastern Europe and Central Asia	Low Income/ Upper Middle Income
Uzbekistan[16]	0.1	5.0	2.7
Kazakhstan[17]	3.1	4.7	6.2
Kyrgyzstan[18]	4.2	5.2	3.5
Tajikistan[19]	1.9	4.6	3.3

The relative importance of pre-payments and cash payments as a share of purchases implies that trade finance products, although offered by banks, are not utilized by traders. All enterprises could potentially use external working capital finance or bridge financing to pay for the inputs they need for production, or input suppliers would be forced to grant more supplier credits to continue operations. Considering the high risk associated with sales to Central Asian importers, however, an increase in suppliers' credits from foreign suppliers may be difficult to negotiate given the current global economic situation.

This report's analysis indicates that while both SMEs and large firms are affected by low levels of financial intermediation, large enterprises would likely be harder hit than SMEs because of their heavier reliance on foreign financing, as foreign investors and lenders are now more risk averse due to problems in the foreign capital markets.

This is further corroborated by the approach taken by general traders, and surgical and sports goods manufacturers exporting or considering export to the CARs. These companies prefer to sell goods on an advance payment basis or cash basis mainly due to the under-developed banking system in the CARs. Although these companies acknowledge the demand for goods from Pakistan, provision of bank intermediated trade finance remains a challenge.

[15] Comparison is with respective geographic region and group of countries with similar incomes.
[16] World Bank- International Finance Corporation, "Enterprise Survey 2013: Uzbekistan"
[17] World Bank- International Finance Corporation, "Enterprise Survey 2013: Kazakhstan"
[18] World Bank- International Finance Corporation, "Enterprise Survey 2013: Kyrgyzstan"
[19] World Bank- International Finance Corporation, "Enterprise Survey 2013: Tajikistan"

Banking Infrastructure and Services in CARs

Vulnerability and Access to Finance

It is imperative to review the stability and resilience of a banking system to better understand the relationship between trade finance availability for direct and indirect exporting and importing entities in the CARs. A snapshot of key indicators of the banking systems in the CARs is provided below.

Table 3: Banking Indicators

	Tajikistan[20]	Kyrgyzstan[21]	Kazakhstan[22]	Pakistan[23]	Afghanistan[24]	Uzbekistan[25]	Turkmenistan
No. of Banks	17	24	38	38	16	30	12
No. of Branches	332	287		10,940	400	4,600	
Total Assets	2.5	2.1	84.9	196	4.4	12 (est.)	
Total Credit	1.2		73.3	39	0.824	5.8	
Total Deposits	1.1	1.3	54	77	3.7 billion		
% of Foreign Currency Deposits	70%	47.6%	37.2%				
Credit to GDP Ratio	22%	20.3% (including Non-Bank Financial Institution - NBFIs)	38.9%	45.8%	4%		
Deposit to GDP Ratio	14%		28.7%		11%		
Loans to SMEs as % of Total Loans			17.5%	6.5%			
NPL %	21%	5.5%	34.8%	13%			
CAR	27% (est.)	24.5%	13.5% (II)	14.9%		23%	
RoA	1.05%	2.8%	1.77%	1.7%			
RoE		17.9%	15.17%	12.2%			
ADR	109%			48.6%	22.6%		

Amounts in USD billions
Data from 2013, blanks indicate data not available
CAR: Capital Adequacy Ratio
RoA: Pre-Tax Return on Assets
RoE: After-Tax Return on Equity
ADR: Advances to Deposit Ratio or Loans to Deposit Ratio

Country Level Analysis

Tajikistan: The spread between borrowing and deposit rates peaked in 2013 at 26-27%, with lending at 30% and deposit rates around the 3% level, indicating a low level of financial intermediation of the banking system.[26] The Tajikistan banking system has limited funding alternatives and remains reliant on central bank funding. There is government-led preferential and directed lending that has caused high levels of non-performing loans (NPLs) in the banking system.

[20] Overview of Tajikistan Financial Sector, IMF (2013)
[21] The Financial Sector Stability Report of The Kyrgyz Republic, National Bank of the Kyrgyz Republic (2013)
[22] Current State of the Banking Sector of Kazakhstan, National Bank of the Republic of Kazakhstan (2014)
[23] State Bank of Pakistan, (2013), http://www.sbp.org.pk/ecodata/index2.asp#monetary4
[24] "Afghanistan's Banking Sector: The Central Bank's Capacity to Regulate Commercial Banks Remains Weak," SIGAR (2014)
[25] "Uzbekistan Banking and Financial System," Japan-Uzbekistan Network for Investment Environment Improvement
[26] Tajikistan Economic Report, World Bank (2014)

Kazakhstan: There are 17 banks that are foreign-owned and 14 subsidiaries of foreign banks. Banking assets contribute to 45% of the national Gross Domestic Product (GDP). There is a high concentration within the banking system with the top 5 banks accounting for 55.4% of the assets, 62.1% of the loan portfolio, and 54.4% of the deposits.[27] The government of Kazakhstan plans to reduce NPLs to 10% by 2015 by deploying USD 1.5 billion to clean up bank balance sheets.

Kyrgyzstan: Reverse stress testing of the Kyrgyz banking system in 2013 revealed that when the capital adequacy ratio is reduced to 12% (the minimum regulatory requirement), non-performing loans increase to 22.3%. Capital adequacy ratio of banks calculated according to the Basel II[28] framework was at 19.4% with no restrictions on foreign currency transactions.[29]

Pakistan: Private and foreign banks control 85% of Pakistan's banking assets. Borrowing accounts for only 3.3% of bank liability. Stress testing of banks conducted by SBP revealed that most banks (30-33 out of 38) would maintain capital adequacy ratios of above 10% if the NPL situation deteriorated. SME finance accounts for only 8% of the total banking system's loan portfolio with a high infection rate of 32%. Commercial banks have not yet been able to make significant progress in serving the more than 3.0 million SMEs in Pakistan, with an estimated finance requirement of PKR 200 Billion.[30]

Afghanistan: The banking sector in Afghanistan remains weak, according to the latest IMF report, with a CAMEL[31] rating of less than 4 for 7 banks that account for 51% of banking assets. Key issues surrounding the banking sector in Afghanistan include the absence of a comprehensive legal infrastructure (credit information bureau), limited institutional capacity of the banking system (weak credit assessment), inadequate corporate governance, low or negative capital, and high credit risk. Financial inclusion also remains a challenge with less than 10% of the adult population holding a bank account and 1.8 bank branches per 100,000 adults in 2011. In comparison, Pakistan has 8.5 branches per 100,000 adults and Iran has 29.1; however, a moveable collateral registry is operational with all banks in Afghanistan that are operating accounts.[32]

Turkmenistan: The financial system is under full state control with 12 national banks. Lending and mobilization savings is not a bank function and these banks mainly lend to state owned enterprises.

Banking systems throughout the CARs generally offer low access to finance for companies (particularly SMEs), low levels of liquidity, large credit spread, and under-developed market-based financial institutions, owing to the influence of governments in lending decisions. This lack of financing facilities creates barriers to building an investment-export nexus that is critical for expanding trade.

The 2013 analysis of Eskhata Bank, Tajikistan, by Moody's Investors Service provides insight into the prevalent banking system in the CARs. Moody's analysis shows Eskhata's ratings remain constrained by weaknesses associated with a potentially volatile operating environment in Tajikistan, stemming from the country's limited economic development, weak institutions, and high levels of dollarization. Given the country's heavy dependence on remittances from Russia (in 2011-12 remittances accounted for around 50% of Tajikistan's GDP), the local economy and the banking sector are highly vulnerable to external shocks -- particularly to a drop in international commodity prices which has the

[27] Current State of the Banking Sector of Kazakhstan, Committee for the Control and Supervision of the Financial Market and Financial Organizations - National Bank of the Republic of Kazakhstan (2014)
[28] The Basel Committee is the primary global standard-setter for the prudential regulation of banks, and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision, and practices of banks worldwide with the purpose of enhancing financial stability.
[29] "The Financial Sector Stability Report of The Kyrgyz Republic," NBKR (2013)
[30] SBP, (2013), http://www.sbp.org.pk/ecodata/index2.asp#monetary
[31] CAMEL: Capital, asset quality, management capacity, earnings quality, and liquidity. This is an international standard for evaluating the credit-worthiness of financial institutions .
[32] IMF Country Report: Afghanistan, IMF (2012)

potential to undermine a major source of foreign exchange (FX), economic growth, and household income.

According to Moody's, an upgrade of Eskhata's ratings is unlikely for the next 12-18 months, given the weaknesses associated with the operating environment in which the bank functions. If economic conditions were to worsen beyond current expectations, downward pressure could be exerted on Eskhata's rating, leading to materially weaker asset-quality profiles, impaired profitability, and weaker capitalization levels.

A review of the banking infrastructure in CARs reveals that their banking systems require:

- Significant strengthening and implementation of regulations and market-based initiatives
- Robust risk management
- Reduced dollarization of deposits
- Deeper and broader financial intermediation

CARs Banking Systems – Key Features

Capitalization and Compliance with International Regulations: Banking systems across all CARs appear to be well-capitalized, as indicated by the capital adequacy ratio in Table 3. Capital adequacy indicates the relationship between risk-weighted assets and the capital (tier I and tier II) of the banking system. The capital adequacy ratio of banks in the CARs is above 8% as required by Basel regulations. Most CARs, however, have not started official implementation of the Basel II framework. Pakistan is Basel II compliant, and the country's Central Bank issued instructions to banks for implementation of Basel III starting December 31, 2013, to be completed by 2019.[33] Basel III has a higher capital requirement for banks compared to Basel II. Most CARs possess some form of a secured transactions regime with different legal frameworks covering moveable and immoveable assets; however, a review of these regulations by EBRD reveals that most of these regulations and laws need to be upgraded to meet international standards.

Level of Financial Intermediation: The depth of financial intermediation remains weak as evidenced by the high advances to deposit ratios, and low advances to GDP and deposits to GDP ratios. The low deposit base signifies a lack of confidence in the banking system and low capacity of the banking system to intermediate funds for economic activity. This increases vulnerability of the banking system, which in turn increases vulnerability of the real economy to availability of financing, since banks do not possess alternative funding sources. During the 2008 global financial crisis, most banks that financed their assets through borrowing were faced with a liquidity crunch and deteriorated risk rating, resulting in reduced lending to enterprises.

Heavy Reliance of Banks on Foreign Currency Deposits: Overall, the banking system of the CARs lacks foreign currency liquidity, negatively affecting the transmission of monetary policy initiatives since the interest rates on the USD are not set according to the economic policy of local governments, but rather by the Federal Reserve to manage the US economy. Furthermore, the banking system is exposed to volatility of foreign currencies (as shown in Table 3) that is not controlled by the central banks of the CARs. Foreign currency funding of banks could translate into potential currency-induced credit risk either for banks or borrowers. In case the bank lends in foreign currency and the revenues of enterprises are denominated in the local currency, the currency-induced credit risk is assumed by the borrower. If the bank lends in local currency, however, then it assumes the potential currency-induced credit risk.

[33] See Annex I for further detail on Basel II and Basel III

Directed Lending: For most countries in the region, their respective central banks control lending by engaging banks in directed lending to certain sectors and borrowers, leading to a high percentage of NPLs. In Tajikistan, for example, the National Bank of Tajikistan has repeatedly lent to default loan borrowers of Agroinvestbank.

Financial Infrastructure: Most banks in the CARs have weak governance and risk management frameworks, deficiencies in regulatory frameworks, and an absence of borrower credit checks, a formal secured transactions regime, and an automated collateral registry system.

NBP operates branches and/or offices in all CARs. It has a strong international presence and can facilitate Central Asian customers in all the major business hubs including Europe, the US, Far East, Middle East, and Asia. It also manages correspondent banking relationships with more than 500 major banks worldwide. NBP offers a range of financial products including trade finance through its branches and offices in the above-mentioned countries. Services offered by NBP could therefore be utilized to increase trade between Pakistan and the CARs. HBL is another large Pakistani bank operating in Afghanistan and Kyrgyzstan.

NBP offers the following products through its branches and offices in the CARs:

- Opening of local and foreign currency accounts of individual and legal entities
- Cash operations (deposit and withdrawal)
- Foreign exchange operations
- Small and medium term loans in local and foreign currency to both individuals and companies at competitive rates
- Issuance of guarantees
- Opening and negotiating of LCs
- International money transfers
- Domestic money transfers

Multilateral Development Banks and Trade Finance Facilitation Programs

Apart from commercial banking facilitation for international trade, various national, transnational and multilateral development banks (MDBs) facilitate international trade finance and cross-border trade. These institutions include the International Union of Credit and Investment (Berne Union), Export Credit Agencies (ECA) governed by the Arrangement of Export Credit Agencies of the Organization for Economic Cooperation and Development (OECD), Exim Banks of countries, the IFC, ADB, EBRD, African Development Bank (AfDB) and Inter-American Development Bank (IDB). Other initiatives such as the Asia-Pacific Trade Insurance Network also provide trade facilitation between member countries.

The banking sector in the CARs currently exhibits features such as low capitalization, market liquidity crunch, and risk aversion. These features are similar to those prevalent in financial markets following the 2008 financial crisis. Therefore, for the purpose of analysis, it is helpful to review some of the institutional initiatives taken by international institutions to respond to the crisis.

After the 2008 financial crisis, global trade finance flow was seriously affected. The Banker's Association for Trade and Finance (BAFT survey 2009) estimated a 6% reduction in the flows of trade finance in developing countries.[34] The credit spread on trade finance activities increased to 200-300 bps above LIBOR from pre-crisis levels of 10-20 bps above LIBOR.[35] This was primarily due to lower confidence in the banking system, market liquidity crunch, risk aversion of banks, and the deteriorated financial and business position of trading companies. This led to further reduction in trade credit by an

[34] "Trade Finance Survey," IMF-Bankers Association for Trade and Finance (2009)
[35] Trade Finance, WTO, 2012

estimated USD 25 billion, or 2.5%, of an estimated trade finance market of USD 10 trillion. According to a recent survey conducted by the ADB on trade and finance, there is currently a global shortfall of USD 1.6 trillion in trade finance, of which USD 425 billion exists in Asia.[36]

To deal with this reduction in trade finance, national governments initiated support and facilitation of trade finance, particularly for SMEs. The governments of France, Germany, Japan, Korea, the UK, the US, and Taiwan took various measures to increase trade finance, including the creation and extension of loan guarantee schemes to SMEs in order to increase their access to liquidity. Other measures included a reduction in tax payments, export facilitation, easing procurement payment procedures, and strengthening pro-investment measures such as a capital base, private equity, and venture capital.

In 2009, the G20 committed to increase the trade finance facilities available by USD 250 billion.[37] The package comprised mainly guarantees provided by export credit agencies and multilateral agencies against commercial and political risk of trading transactions. The packages restored confidence and stabilized trade finance markets fairly rapidly, and have largely been viewed as successful.

To counter the reduction in availability of trade finance, the G20 governments and multilateral institutions, including the World Bank, the World Trade Organization (WTO) and the IMF encouraged MDBs such as IFC, ADB, IDB, AfDB and EBRD to increase their commitments to facilitate trade finance. This led to a USD 6.6 billion increase in availability of trade facilities, financing approximately USD 30 billion of trade that involved developing countries and had an average value per transaction of USD 250,000.[38]

Table 4: Increase in Trade Facilities by MDBs[39]

MDB	Type	Pre-2008	Year (previous)	Increase
IFC	North-South	USD 1.5 billion	USD 5 billion	USD 3.5 billion
IADB	North-South	USD 0.5 billion	USD 1.0 billion	USD 0.5 billion
EBRD	North-South	USD 1 billion	USD 2.0 billion	USD 1.0 billion
ADB	South-South	USD 0.4 billion	USD 1.0 billion	USD 0.6 billion
AfDB	South-South	-	USD 1.0 billion	USD 1.0 billion
Total		**USD 3.4 billion**	**USD 10 billion**	**USD 6.6 billion**

Key elements of the trade facilities offered by MDBs are listed below:

IFC Global Trade Finance Program[40] deployed USD 5 billion facilitating 265 issuing banks in 94 developing countries. IFC also operates a global trade liquidity program to support trade in developing countries. The program offers banks partial or full guarantees to cover payment risk on banks in emerging markets. These guarantees are transaction-specific and apply to LCs, trade-related promissory notes and bills of exchange, bid and performance bonds, advance payment guarantees and supplier credits for the import of capital goods. Initially it was targeted at the agribusiness and food sector but since 2012 has been extended to trade and commodity finance.

Asian Development Bank (ADB)[41] provided support worth USD 4 billion for transactions in 2012. With a client base of more than 200 partner banks in 18 Asian countries (developing member countries including Pakistan), ADB's trade finance program offers credit guarantee, a risk participation

[36] Ibid
[37] "Trade and Investment Measures," OECD, WTO OMC, UNCTAD (2010)
[38] "Trade Financing and Regional Financial Institutions from a South-South Perspective," UNCTAD (2012)
[39] Ibid
[40] "Rethinking Trade & Finance," ICC (2013)
[41] "Trade Finance Program 2012," ADB (2012)

agreement, and revolving credit facility depending on the risks and composition of trade that is involved.

European Bank for Reconstruction and Development (EBRD) trade facilitation program has almost doubled in value since the aftermath of the 2008 financial crisis to €1.5 billion.[42] The program has supported a total transaction of up to €8.2 billion since 1999. It can guarantee any genuine trade transaction to, from, and between the countries of operations with a large range of products.

African Development Bank (AfDB) Trade Finance Initiative Program[43] commenced in March 2009 with a total of USD 1 billion and provides particular support to African financial institutions aimed to facilitate their own trade finance operations. The program currently serves 101 issuing banks in 22 countries and has products such as a Risk Participation Agreement (RPA), Trade Finance Line of Credit (TFLOC), and Soft Commodity Finance Facility. More recently, in March 2013, the AfDB launched a new and more ambitious Trade Finance program and is planning to expand this initiative to a USD 10 billion trade finance program by 2015.

The Inter-American Development Bank's Trade Finance Facilitation Program *(TFFP[44])* currently comprises a network of 231 confirming banks from 87 different international banking groups, and 67 issuing banks in 18 Latin American and Caribbean countries, with more than USD 1.16 billion in approved credit lines. To date, IDB has provided loans and issued guarantees of over USD 750 million to support around 1,000 individual trade transactions of more than USD 1 billion.

The Berne Union (International Union of Credit and Insurance[45]) was established in 1934 by private and state credit export insurers to actively facilitate cross border trade by supporting internationally acceptable principles of export credits and foreign investments. The Union's 79 members collectively insured USD 1.8 trillion in exports and foreign direct investment – more than 10% of international trade.

Export Credit Agencies and Exim Banks

Landscape in Pakistan

National governments provide export credits[46] through ECAs to support local exporters competing for overseas sales. Such support can either take the form of "official financing support" such as direct credits to foreign buyers, refinancing and interest-rate support, or of "pure cover support" such as export credits insurance and guarantee cover for credits provided by private financial institutions. ECAs can be government institutions as well as private companies operating on behalf of governments.

In 2001, the ADB established an ECA in Pakistan: the "Pakistan Export Finance Guarantee Agency". It was part of the larger ADB initiative "Trade Export Promotion and Industry" (TEPI), since improving export performance and development of SMEs were identified by the ADB as key factors required for Pakistan's macroeconomic stabilization.[47]

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[42] Ibid
[43] Ibid
[44] "Rethinking Trade & Finance," ICC (2013)
[45] Ibid
[46] Broadly defined, an export credit is an insurance, guarantee, or financing arrangement that enables a foreign buyer of exported goods and services to defer payment over a period of time (OECD, 2001). Export credits are generally divided into short term (usually under two years), medium term (usually two to five years), and long-term (usually over five years). Export credits may take the form of *supplier credits* that are extended by the exporter, or *buyer credits* for which the exporter's bank or some other financial institution lends to buyers (or their banks).
[47] Pakistan: Small- and Medium-Size Enterprise Trade Enhancement Finance Project Validation Report, 2008, ADB

The Project had four components:

1. Foreign Currency Export Finance Facility (FCEF) of USD 150 million loan to provide export financing for SMEs and emerging exporters.
2. Partial risk guarantee facility of an additional USD 150 million for international commercial banks that confirm import LCs issued by Pakistani commercial banks at the request of eligible exporters, to facilitate the availability of imports required for export production and reduced transaction costs, thereby enhancing the competitiveness of exports.
3. Equity investment of USD 2 million in the Pakistan Export Finance Guarantee Agency Limited (PEFGA) to reduce the collateral burden of exporters and to mitigate the risk of pre-shipment financing.
4. Technical Assistance of USD 0.8 million for the institutional strengthening of the EPB, with the first phase focusing on a review of the EPB strategic plan and the second phase focusing on capacity development, especially a management information system and staff training needs.

Although the initiative was aligned with the priorities of the GoP and other stakeholders, it was unsuccessful, as it failed to achieve its targeted outcomes pertaining to export-led economic growth, employment generation, and poverty reduction.

The GoP has recently initiated the process of establishing an Exim Bank as per the Exim Bank Initiative in the Strategic Trade Policy Framework for 2012-2015. It is currently in the process of drafting a bill to be proposed to the parliament for approval and is allocating PKR 10 billion for the Exim Bank in the Federal Budget 2014-2015. The government plans to study various regional and international models for determining objectives, policies, mark-ups, products, and services for the Exim Bank. To drive the initiative forward, a committee has been formed consisting of the Governor of the State Bank, Secretary Finance, and Secretary Commerce. The committee has constituted a working group comprising the Executive Director of SBP, one member from the MoC, and one from the Ministry of Finance. The SBP will lead the initiative, and has decided to hire a consultant to assist the committee and working group.

International Landscape

The OECD has provided an arrangement to develop, maintain, and monitor the financial discipline of ECAs. There are 31 official ECAs that provide financial support to exporters in their respective countries. The current participants of the OECD arrangement, however, only include Australia, Canada, the EU, Japan, Korea, New Zealand, Norway, Switzerland and the US. In addition, Israel and Turkey are observers to participant meetings, and other organizations such as the Berne Union, EBRD, IMF, United Nations Environment Programme (UNEP), the World Bank, and the WTO are invited to meetings when issues of mutual interest are discussed.

Facilities offered by ECAs include:

1. Export credit guarantee or insurance
2. Official financing support
    a. Direct credit/financing and refinancing
    b. Interest rate support
3. Any combination of the above

The main terms and conditions of the ECA arrangement[48] are as follows:

Down-Payment: 15% of the export contract value at or before the starting point of the credit.

[48] "Arrangement On Officially Supported Export Credits," OECD, 2014

Maximum Repayment Term: 5 years for category I countries (high income as defined by the World Bank) and 8 years for category II countries (all other countries).

Repayment: No less frequently than 6 months with the first installment of interest and principal no later than 6 months after the starting point of credit.

Maximum weighted average life of repayment:

1. For sovereign buyers, four and one-half years for category I, and five and one-quarter years for category II
2. For non-sovereign buyers, five years for category I and six years for category II

Common products offered by Exim Banks include:

1. Financing for local companies to invest abroad
2. Line of credit for financial institutions and corporations
3. Export credit insurance
4. Working capital
5. Supply chain credits

Exim Banks

There is a wide range of Exim Banks that support exports of their own countries. Depending on the scope of the market and scale of operations, Exim Banks issue commercial and standby LCs, loans for imports and exports, insurance, and guarantees. Such Exim Banks include, for example, the Ex-Im Bank of the United States, Export Credits Guarantee Department (ECGD) UK, Export Finance and Insurance Corporation (EFIC) of Australia, Exim Bank of India, Export Credit Insurance Corporation of South Africa, Export Development Corporation (EDC) of Canada, Export-Import Corporation of Singapore, and the Nigerian Export-Import Bank.

Export Credit Agencies (ECAs)

Efforts to improve the quality and efficiency of export credit products and services primarily benefit SMEs and other smaller enterprises. OECD countries are also increasingly targeting small exporters in their export promotion programs. The Export Credits Guarantee Department (ECGD) of the UK clearly states in its 2000 *Mission and Status Review* that it is seeking to attract more SME customers and raise awareness of export insurance and finance among smaller exporters. The Canadian EDC is encouraging small firms in Canada to actively export their products. Similarly, the Korea Export Insurance Corporation (KEIC) is also encouraging SME export activities through an article of special treatment for small firms contained in the *Korean Export Insurance Act*. United States' support for SMEs is based on the legislative mandate of the Ex-Im Bank; the *Corporate Plan* of the Australian EFIC also explicitly underlines support for small firms.

The developed world is focusing heavily on promoting SMEs. The US Ex-Im Bank, for example, comprises a *Small and New Business Group* with a staff of around 120 people in three divisions: 1) insurance, 2) working capital, and 3) business development. The EDC of Canada has established two teams to support small firms: 1) the *Emerging Exporters Team* delivers short-term insurance services through a specialized underwriting center which can issue policies and grant buyer credit approvals immediately over the phone, fax, or internet; and 2) the *Small Business Financial Solutions Team* which delivers medium-term and long-term products and services, including buyer credit financing, contract bonding, and pre-shipment financing. Similarly, the Japan Bank for International Cooperation (JBIC) has set up an *Advisory and Consulting Office for SMEs* which offers advisory and consulting services to support small firms.

Financial products and services for smaller exporters may or may not be different from regular products provided by ECAs. Some OECD countries are introducing short-term products, such as export credit insurance and export-related capital guarantees, especially designed for small exporters. These include programs such as in Hungary for the provision of insurance against exchange risks, and in Finland for general financing to support domestic operations and internationalization efforts for SMEs.

The Basel Committee sets global standards for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision, and practices of banks worldwide with the purpose of enhancing financial stability. The Basel Committee has over time provided Basel I, II, and III frameworks for strengthening the global banking system.

Following consultations with the World Bank, WTO, and ICC, the Basel Committee on Banking Supervision has evaluated the impact of Basel II and III on trade finance in the context of low-income countries and implemented certain changes to Basel II and Basel III to support banks in increasing availability of trade finance products for trade with developing countries. These adjustments to Basel II and Basel III have therefore had a direct positive impact on banks in Pakistan to assume risk on banks in the CARs. Details of changes made to Basel II and III are provided in Annex I.

Recommendations

Recommendations for improving the availability of trade finance as a tool for enhancing trade between the CARs and Pakistan are provided below.

Short Term

1. **Mark-Up Rate Reduction**: Introduce a reduction in the mark-up rate of 200-300 bps on export re-finance facility for exports to the CARs. This facility could be made available for certain priority sectors or in general for all exporters to the CARs.

2. **Credit Enhancement**: NBP and HBL could offer acceptance/usance LCs to importers in the CARs for importing goods from Pakistan. This facility could be backed by credit enhancement either from the GoP or from the ADB and IFC under their Global Trade Finance programs to provide a geographically specific guarantee to NBP and HBL. LCs would mitigate the additional risk on importers in CARs for imports from Pakistan and would allow the two banks to utilize their regional branch networks, local large corporate client base, and strong capital position to facilitate trade between Pakistan and the CARs. Consequently, this initiative would increase the number of importers of Pakistani products in the CARs by providing a trade credit facility. It would also allow private sector exporters in Pakistan with no local contacts in the CARs to initiate trade on a secured basis. Export against usance LCs would provide exporters with a risk cover against non-payment and allow for immediate cash payment through discounting of the bill of exchange.

Medium Term

Development of Regional ECA/Pakistan's Exim Bank: Setting up an Exim Bank in Pakistan and an ECA targeting trade within the region would help mitigate risks for exporters and importers by assuming commercial and political risks in the country of import. Pakistan established an ECA with the assistance of the ADB in 2001 but the initiative failed to achieve its targets and was hence discontinued.

1. **Developing Regional Supply Chains:** Commercial banks such as HBL and NBP that are present in both Pakistan and the CARs could initiate a program to facilitate investment from companies in the region for the purpose of developing regional supply chains. Investing in sectors of comparative advantage, companies could develop these supply chains for onward exports to international markets and sales in the region.

2. **Regional Guarantee Scheme for SMEs**: SMEs in the region have low access to finance, limiting their investment and export potential. To build a strong SME investment-export nexus, the regional central banks, MDBs and donor agencies could develop a regional partial guarantee funding scheme for lending to SMEs engaged in, or with the potential to engage in, regional trade. This initiative would allow banks to explore the SME market segment and lend to SMEs with a lower perceived risk.

Long Term

1. **Regional Development Bank for Pakistan, Afghanistan and the CARs:** A south-south regional development bank for Pakistan, Afghanistan, and the CARs would potentially be better equipped to understand the financing needs of the region as opposed to a north-south MDB. The suggested regional development bank would pool risks and mobilize international funding for regional investment. The bank would focus its investment in sectors that would increase trade in the region by reducing the prevalent barriers to trade. These sectors would include infrastructure (rail network, roads, and airlines), energy, and logistics. The bank could also enter into financing agreements with ECAs at a lower cost and preferential financing terms and conditions. It would be a platform to channel funding to under-developed economies within the region.

2. **Harmonization of Financial Sector Policies and Institutions in the Region**: Regional cooperation among central banks, clearing houses, and commercial banks would allow for regulatory frameworks to be synchronized and for policy initiatives undertaken to meet the needs of the real economy for investment. It would also help address existing barriers to regional trade. This initiative could be institutionalized through the formation of a regional group of central banks with representation from each country. Such a group would enhance knowledge-sharing and hence result in faster development of the banking systems in the region.

3. **Development of Regional Impact Equity Fund**: The fund could be sponsored in one of the countries or an off-shore location, supported by MDBs. The fund would invest in SMEs exporting in the region. It would also invest in banks and financial institutions, social sectors, and regional supply chain companies. This would allow companies in different countries of the region to explore their sectoral markets, expand, transfer technology and expertise, and increase trade and investment in the region.

Annex I – International Regulations for Trade Facilitation

Liquidity Requirements – Basel III Framework

Requirements for the liquidity of financial institutions have been strengthened by Basel III regulations through the introduction of the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

The LCR is a measure designed to ensure that a bank can still meet all its obligations, such as making payments and allowing cash withdrawals, for at least 30 days, even if its normal sources of funding are cut off or if there is a run on the bank. Banks are expected to hold a part of their assets in the form of cash and securities, such as government bonds, that are easily convertible into cash. For contingent obligations stemming from trade finance instruments, a low run-off rate of 5% or less is suggested by the Basel Committee and might be a good benchmark before the final decisions are made by national authorities. For medium and long-term ECA loans, the mitigation factor of 10% to 40% on the off-balance sheet commitments introduced in January 2013 will also have to be confirmed.

The NSFR attempts to ensure that the maturity of assets and the liabilities funding them are well-matched in order to enhance stability. It is based on prescribed assumptions on the liquidity characteristics of various balance sheet items and requires that 85% of short-term lending to SMEs and 50% of short-term lending to corporates must be funded by long-term liabilities. This means that short-term on-balance sheet trade finance instruments, such as invoice finance, will become more expensive to fund, since long-term funding usually costs more than short-term funding. There are no proposals as yet for off-balance sheet exposures like LCs, which are left to national authorities.

Increased Capital Requirements – Basel III Framework

The amount of capital that banks will need to hold against their exposures will increase in a number of areas under Basel III:

Capital for Counterparty Risk: One area that the Basel III regulations seek to address is the interconnected and interdependent nature of relationships between financial institutions and their greater sensitivity to the economy. To achieve this, banks will be required to apply a multiplier to the Asset Value Correlation (AVC) for exposures to large regulated financial institutions and unregulated financial institutions. As a result, they will hold more capital against these exposures than under earlier rules. For trade finance this is significant because many LCs, such as confirmed LCs, result in bank-to-bank exposures and so will attract relatively more capital.

Across-the-Board Increases in Capital and Improvements in its Quality: The overall amount of high-quality capital held by many banks, such as retained earnings and paid-in capital, was found to be inadequate during the crisis. Under Basel III, banks will need to hold more high-quality capital.

Minimum Capital Requirement due to Cap on Leverage: The minimum amount of capital that must be held against any exposure is set at 3% (on- or off-balance sheet). For most instruments, the capital requirement will be above this regulatory minimum; however, the capital requirement for short-term off-balance sheet trade finance instruments, such as LCs, will typically be lower than the regulatory minimum. This could potentially dramatically increase the amount of capital required for short-term off-balance sheet trade finance instruments.

Changes in Basel II and III Frameworks for Low-Income Countries

Following consultations with the World Bank, WTO, and ICC, the Basel Committee on Banking Supervision has evaluated the impact of Basel II and III on trade finance in the context of low-income countries.

As a result of this evaluation, the Committee has adopted two changes to the treatment of trade finance in the Basel II and III capital adequacy framework. These changes respect the integrity of the capital framework and its broader financial stability objectives.

The changes to the capital framework agreed by the Committee are as follows:

1. Waive the one-year maturity floor for certain trade finance instruments under the advanced internal ratings-based approach (AIRB) for credit risk.
2. Waive the so-called sovereign floor for certain trade finance-related claims on banks using the standardized approach for credit risk.

The above changes would provide the regulatory cover for international banks and those in Pakistan to assume counter-party risks on banks in the CARs. This would potentially provide a stop-gap arrangement until the time banks and banking systems in the five CARs and Afghanistan can strengthen their lending positions.